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Striking a balance between financial innovation and regulation

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However, inappropriate use of innovation increases risk in the system, as we saw in the multiple tiers of securitisation of sub-prime loans into mortgage-backed securities and layers of CDOs. Similarly, in the CDS market, we saw a phenomenal growth as investors with no insurable interest in the reference entities also bought protection against default, or sold protection through synthetic CDOs. They bought or sold depending on their view of likelihood of default of the reference entities. Well, we know what happened to safe bets like Lehman and AIG.

In between the two extremes for and against innovation, there is a view that there is a role for financial innovation but such innovation must be subject to appropriate regulatory oversight. This is to ensure that financial innovations do not expose investors to risks that they do not understand or are unable to bear, and that the market in these new products does not undermine the orderly functioning of markets or pose a threat to financial stability. This is a sensible approach, and regulators are largely in this camp.

There have been calls for financial institutions to “go back to basics”, and that finance should focus on capital allocation for productive use and in helping the economy in risk management. The financial system should grow in tandem with, and not overtake, the real economy. Financial institutions should create products that meet the needs of their customers, and search of higher yields, and there have been many complaints around the world of staff not understanding what they were selling, as well as allegations of mis-selling. So, it appears that banks had moved into new business activities that have escaped regulation, and banks have not upgraded their risk management systems and expertise, exposing their customers and the banking system to new and unknown risks.

Should banks then be allowed to continue to engage in non-banking activities or should they focus on narrow banking? One view is that banks should operate like a utility (deposit taking and lending, and payments system) and not a casino (investment banking), if they are to enjoy lender of last resort facilities and government support in the event of failure. This is one way of reducing interconnectedness among financial institutions, so that non-banks can be allowed to fail without threatening stability.

Another view is to allow non-banking business, but the unregulated aspects of their business should be brought onto the balance sheet and subject to capital and liquidity requirements and properly risk managed. However, concerns remain on how to deal with the moral hazard of “too big to fail”. To deal with this, there are proposals to set up orderly resolution arrangements so that non-banks that are systemically important would be assisted to have an orderly wind-down but they would not be bailed out. The UK is also looking into “living wills” or contingency plans of financial groups to deal with orderly winding down in the event of failure.

To address concerns relating to financial innovations, the regulatory response includes strengthening customer suitability rules, greater clarity in the disclosure of risks that is understandable to investors, tightening selling practices, and better risk management. The US is introducing new consumer protection legislation. Investor education is another important supervisory tool that is being reinforced.

The approach of Hong Kong

In Hong Kong, the Securities and Futures Ordinance provides that in performing its functions, the SFC should have regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre (IFC); the desirability of facilitating innovation; and the principle that competition should not be impeded unnecessarily.

Our approach in regulating the securities market in Hong Kong is to:

- Complexity – the products were too complex and risk disclosures were ineffective in alerting investors; and
- Suitability – that as a result of the above, and the failure of brokers and banks to do proper customer due diligence, inexperienced retail investors were left holding products not suitable to their investment profile.

To address this, the SFC has issued a consultation paper on proposals to strengthen our regulatory regime regarding the sale of investment products to retail investors and better protect the interests of investors:

- The first part is in relation to the way in which disclosure on product risks and features should be enhanced and the obligations that the product issuer or arranger should bear;
- the second part is in relation to revisions to be made to the Code of Conduct which, as we all know, governs intermediary conduct and selling practices;
- the last part involves a newly introduced cooling-off concept for long term illiquid products.

Equally important are the proposals on the establishment of the Investor Education Council and Financial Dispute Resolution Mechanism. On the international front, the SFC would continue to benchmark its regulation to international standards or higher, if it better suits Hong Kong.

Concluding remarks

Financial innovation does bring benefits, but it must be subject to appropriate regulatory oversight.

The world is undergoing the greatest overhaul of financial regulation since the Great Depression. However, there is no perfect solution, as you can see from the many different view points on how to address the issues. What we end up with is the best in the circumstances, taking into account the views of stakeholders. The more important challenge is successful implementation once the regulations are in place.

The world is also aware that crisis cannot be eliminated. So we should be on our guard to try to spot new risks and deal with them, so that the impact would be less devastating the next time round.

Finally, regulation is no substitute for discipline on the part of all stakeholders. It is in the interest of everyone – market players, intermediaries, investors, and regulators – to play their part in conducting themselves in a responsible and professional manner so that we can safeguard the continued functioning and stability of financial markets and maintain economic prosperity.